HaRe Group newsletter: **11 November 2016**

Subject: **Ineffective vs Inspired LTI plans**

All companies and their shareholders want success. In a competitive market, any organisation's success depends on the quality of its business leaders and their engagement with strategic goals. However, all company executives also seek their own success, however they define it, and the majority expect personal financial gains in return for their achievements.

For decades, most listed companies in Australia have delivered shares to executives as a financial reward for contributing to business success. These shareholdings have been delivered in many ways, but more recently, under the scrutiny of proxy advisers, they have become overly complex with a tangle of performance hurdles and vesting conditions that diminish and dissociate remuneration value.

This subject has been examined by the UK-based ***Executive Remuneration Working Group*** (ERWG). In their July 2016 report, the ERWG wrote of their concern that executive remuneration has become too complex and is not fulfilling its purpose, and this complexity has contributed to poor alignment between executives, shareholders and the company.

In Australia, we see a similar situation. To satisfy proxy advisers, the boards of many companies believe that they should adopt a one-size-fits-all Long Term Incentive (LTI) plan. The common model is a performance rights plan that includes up to three performance measures over a three year period. The measures may be popular with shareholders, but unsuited to a company's strategy, and some organisations cannot fairly predict long term business conditions.

The frequent outcome for executives is an LTI plan that dissociates their contributions from the success of the business and diminishes their perceptions of remuneration value – ie. executives often find no incentive in share based remuneration because the likelihood of the reward is unpredictable and seemingly minimal.

The conclusions reached by the ERWG are worthy of consideration in Australia. For example:

- Vesting periods (including holding terms) over five years are demotivating (given the average tenure of an executive is less than five years)
- Performance measures should reflect business strategy - shareholder expectations of market relative measures (like relative Total Shareholder Return) may exacerbate executive perceptions that the LTI is a lottery
- Market priced share options don't have a symmetrical association with company success – options give executives a disproportionate upside for good performance and no downside for poor performance
- Zero priced share options (performance rights) are suitable for mature companies in a stable market where long term performance is predictable
- Granting restricted shares that conditionally vest over a period are better for companies that suffer external factors, or have great difficulty in predicting long term performance targets
- Converting an annual bonus into shares that conditionally vest over a period are better for companies with short business cycles (such as retail)

Above all this, every company needs a crystal clear reward strategy that echoes its business strategy. The LTI plan should have objectives to motivate each executive – eg. to stay with the company and keep future-focused. A complex LTI plan with meaningless targets and a lottery result will fail its objectives. Shareholders need to become familiar with the realities of their company's long term strategy and market conditions, and how these circumstances should guide a more inspired LTI plan design.

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Performance & reward solutions, including the Remuneration Planning System